

REPORT OF EXAMINATION
FAMILY LIFE INSURANCE COMPANY

Seattle, Washington

December 31, 1998



States Participating:

Washington
Delaware
Montana
Oregon

I hereby certify that the attached Report of Examination shows the financial condition and affairs of FAMILY LIFE INSURANCE COMPANY of Seattle, Washington as of December 31, 1998.

Patrick H. McNaughton
Chief Examiner

Date

FAMILY LIFE INSURANCE COMPANY

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FAMILY LIFE INSURANCE COMPANY

Seattle, Washington
June 28, 2001

Hon. Kathleen Sebelius
Commissioner, Kansas Insurance Dept.
Chair, NAIC Financial Condition (EX) Committee
420 SW 9th Street
Topeka, KS 66612-1678

Hon. Bob Lohr
Director, Alaska Division of Insurance
NAIC Secretary, Western Zone
3601 C Street, Suite 1324
Anchorage, AK 99503-5948

Hon. Donna Lee Williams
Commissioner, Delaware Department of Insurance
NAIC Secretary, Northeastern Zone
841 Silver Lake Boulevard
Dover, DE 19904

Hon. Mike Kreidler
Commissioner, Washington State
Office of Insurance Commissioner
PO Box 40255
Olympia, WA 98504-0255

Dear Commissioners:

In accordance with your instructions and in compliance with the statutory requirements of Chapter 48.03, Revised Code of Washington (RCW), an examination was made of the corporate affairs and financial records of

FAMILY LIFE INSURANCE COMPANY

of

Seattle, Washington

hereinafter referred to as the "Company" or "FLIC", at its home office located at 2101 4th Avenue, Suite 700, Seattle, Washington 98121-2371 and its administrative office located at 6500 River Place Blvd., Building One, Austin, Texas 78730.

The Report of Examination is respectfully submitted showing the condition of the Company as of December, 31, 1998.

SCOPE OF EXAMINATION

As required by RCW 48.03.010, this Association examination covered the five-year period from January 1, 1994 through December 31, 1998. The Company was last examined as of December 31, 1993 by examiners representing Washington, Mississippi, and Montana. Examiners from the states of Delaware, Oregon, Washington and an actuary from Montana participated in the current examination. The examination was conducted concurrently with the Association examination of Investors Life Insurance Company of North America (ILINA), an affiliated insurance company, domiciled in the state of Washington.

The examination followed the statutory requirements contained in the Washington Insurance Code and the guidelines prescribed in the NAIC Financial Condition Examiner's Handbook. The Company's operating procedures and financial records were reviewed as considered necessary to ascertain the financial condition of the Company and conformity with related laws. These matters are discussed in various sections of the report. The examination also included identification and disposition of material transactions and events occurring subsequent to December 31, 1998.

FAMILY LIFE INSURANCE COMPANY

INSTRUCTIONS

The examination findings require the following instructions to the Company:

1. Comply with RCW 48.03.030 requiring free accessibility to accounts and records and 48.05.280 requiring full and adequate accounts and records. (See Page 11, "Accounting Records")
2. Amend the custodial agreement to include the standard as required by the NAIC and in compliance with RCW 48.03.025. (See Page 9, "Other Agreements")
3. Comply with the four-percent limitation contained in RCW 48.13.160(4)(b) on the cost of each parcel of real property acquired. Comply with RCW 48.13.140(1) and 48.13.350(2)(c) regarding appraisal of and documentation of investment in real estate property. Document the type or classification of the acquired real estate known as the Bridgepoint Five Building. (See Page 22, "Real Estate: Investment real estate")
4. Comply with RCW 48.13.140(2) regarding the maintenance of hazard insurance on the real property for either home office or investment in real estate. (See Page 22, "Real Estate: Investment real estate")
5. Comply with RCW 48.31B.030 (1)(a)(iv), RCW 48.05.250, and WAC 284-07-050(2), regarding the recording and annual statement disclosure of the Company's transactions with affiliates. (See Page 22, "Real Estate: Investment real estate")
6. Comply with RCW 48.05.280 regarding reconciliation of its bank accounts on a monthly basis; establish an escheat account and discontinue carrying a considerable number of old, outstanding checks; and close one inactive checking account. (See Page 18, "Cash on hand and Short term investments")
7. File a SAR with the NAIC SVO for the Money Market Funds to be included on the Exempt Money Market listing in compliance with RCW 48.03.025 and WAC 284-07-050(2). (See Page 18, "Short term investments")
8. Change its method of determining the amount of federal income tax recoverable in compliance with RCW 48.05.280. (See Page 18, "Federal Income Tax Recoverable")
9. Comply with RCW 48.05.280 regarding maintenance of a comprehensive file of the procedures followed and of data sources used to prepare actuarial assets and liabilities that would facilitate actuarial examinations. (See Page 20 (E), "Life Policy and Contract Claims")
10. Review and modify, if necessary, the reserving methodology and procedures applicable to its universal policies in compliance with RCW 48.74.050(1) and 48.74.060. (See Page 20(E), "Life Policy and Contract Claims")
11. Review the appropriateness of the reserve treatment under its bulk ADB reinsurance agreement in compliance with RCW 48.12.160(1). (See Page 20(E), "Life Policy and Contract Claims")
12. Review the appropriateness of its deficiency reserve calculations in compliance with RCW 48.05.280 and 48.74.030. (See Page 20(E), "Life Policy and Contract Claims")
13. Review the calculations and reserving practices that have sound actuarial bases in compliance with RCW 48.74.030. (See Page 21(E), "Life Policy and Contract Claims")
14. Adopt a methodology for estimating the liabilities for outstanding death claims that reflects reporting delays in compliance with RCW 48.74.030. (See Page 21(E), "Life Policy and Contract Claims")
15. Comply with RCW 48.05.250 for future filing of its Annual Statement regarding proper reporting of asset valuation reserve. (See Page 21(F), "Asset Valuation Reserve")

FAMILY LIFE INSURANCE COMPANY

16. Comply with RCW 48.12.160(1) in taking reserve credit for reinsurance ceded. (See Page 19, "Aggregate Reserve for Life Policies and Contracts")
17. Comply with RCW 48.31B.030(1)(b)(iv) and 48.31B.025(2)(c)(vi) regarding separate catastrophe reinsurance agreement. (See Page 10, "Reinsurance")
18. Comply with RCW 48.05.250 regarding proper listing of affiliates or subsidiaries in Schedule Y of the 1998 Annual Statement. (See Page 10, "Reinsurance")
19. Comply with Chapter 284-95 WAC regarding proper transfer of insurance contracts. (See Page 11, "Reinsurance")

COMMENTS AND RECOMMENDATIONS

The examination developed the following comments and recommendations:

1. The Company should include in its asset for cash one inactive checking account. (See Page 18, "Cash on hand and Short term investments")
2. The Company should obtain a fidelity bond with the NAIC suggested minimum amount. (See Page 8, "Fidelity Bonds")
3. The Company should thoroughly review the liability "Remittances and Items Not Allocated" and either fully and properly apply the amounts in suspense or refund the amounts received to the appropriate party. The Company should also make its correcting adjustments in a more timely manner in order to properly indicate the true balance of this liability. (See Page 11, "Accounting Records")

HISTORY

The Company was incorporated under the laws of the state of Washington as a stock life insurance company on June 1, 1949. The Company became a wholly owned subsidiary of Merrill Lynch & Co., Inc., in 1974. In 1986, the Company formed a wholly-owned subsidiary, Merrill Lynch Life Insurance Company (MLLIC). MLLIC's common stock was dividended to Merrill Lynch & Co., in 1991 with the approval of the Washington Office of the Insurance Commissioner.

The transaction occurred in conjunction with Financial Industries Corporation's (FIC) acquisition, through two intermediary companies of FLIC, for \$114 million in June of 1991. The Company recapitalized at that time, issuing \$14,000,000 of preferred stock, \$2,500,000 of common stock and a surplus debenture of \$97,500,000 to its immediate parent, Family Life Corporation (FLC).

CAPITALIZATION

The Articles of Incorporation of the Company were amended on March 10, 1989 to increase the authorized common stock from 212,368 shares to 250,000 shares. The shares were then issued as a stock dividend. The Articles of Incorporation were amended again on May 22, 1991 to increase the total number of authorized shares of stock to 725,000 shares, divided in to two classes as follows:

1. 500,000 shares of voting common stock, with a par value of \$10 per share (the "Common Stock"), and
2. 225,000 shares of cumulative redeemable preferred stock with a par value of \$100 per share (the "Preferred Stock").

FAMILY LIFE INSURANCE COMPANY

Common Stock:

	<u>Authorized Shares</u>	<u>Shares Outstanding</u>	<u>Par Value</u>	<u>Capital Paid-Up</u>	<u>Paid In and Contributed Surplus</u>
12/31/93	500,000	250,000	10	2,500,000	3,500,000
12/31/94	500,000	250,000	10	2,500,000	3,500,000
12/31/95	500,000	250,000	10	2,500,000	3,500,000
12/31/96	500,000	250,000	10	2,500,000	3,500,000
12/31/97	500,000	250,000	10	2,500,000	3,500,000
12/31/98	500,000	250,000	10	2,500,000	3,500,000

Preferred Stock:

	<u>Authorized Shares</u>	<u>Shares Outstanding</u>	<u>Par Value</u>	<u>Capital Paid-Up</u>
12/31/93	225,000	191,777	100	19,177,723
12/31/94	225,000	202,564	100	20,256,359
12/31/95	225,000	202,564	100	20,256,359
12/31/96	225,000	202,564	100	15,192,300
12/31/97	225,000	202,564	100	15,192,300
12/31/98	225,000	202,564	100	15,192,300

Dividends Paid to Shareholders

During the period under this examination, no common stock dividends were paid. Dividend payments were made, as called for by the terms of the preferred stock, during 1994 in the form of additional shares of preferred stock. No cash dividends were made on the preferred stock during the period under this examination.

MANAGEMENT

Stockholders

The Company is a wholly owned subsidiary of Family Life Corporation (FLC); a Washington domiciled corporation, which was formed in 1991. FLC was a wholly owned subsidiary of Family Life Insurance Investment Company (FLIIC) from 1991 until December 1998, when FLIIC was dissolved. The 1998 dissolution and reorganization did not significantly alter the Company's management and control structures or relationships.

Board of Directors

The Bylaws of the Company provide that each director be elected at the annual meeting of the stockholders. Vacancies on the Board may be filled by a majority vote of the remaining members.

FAMILY LIFE INSURANCE COMPANY

The following directors, officers, and committee members are serving the Company as of December 31, 1998:

<u>Directors</u>	<u>Position and Principal Business Affiliation</u>	<u>Residence</u>
Roy Frank Mitte	Chairman, President and Chief Executive Officer, FIC and ILCO	Austin, TX
Jeffrey Harrison Demgen	Executive Vice President of Sales and Marketing	Austin, TX
Theodore Adams Fleron	Senior Vice President, General Counsel And Assistant Secretary	Austin, TX
James Martin Grace	Executive Vice President, Chief Financial Officer, Treasurer and Asst. Secretary	Austin, TX
Dale Edwin Mitte	Senior Vice President	Austin, TX
Eugene Edgar Payne	Executive Vice President, Chief Administrative Operations Officer and Secretary	Austin, TX
Steven Paul Schmitt	Senior Vice President and Assistant Secretary	Austin, TX

Officers

<u>Name</u>	<u>Title</u>
Roy Frank Mitte	Chairman of the Board, President and Chief Executive Officer
James Martin Grace	Executive Vice President, Chief Financial Officer, Treasurer and Asst. Secretary
Eugene Edgar Payne	Executive Vice President, Chief Adm. Operations Officer and Secretary
Jeffrey Harrison Demgen	Executive Vice President of Sales and Marketing
Theodore Adams Fleron	Senior Vice President, General Counsel and Assistant Secretary
Steven Paul Schmitt	Senior Vice President and Assistant Secretary
David Clark Hopkins	Senior Vice President and Assistant Secretary
Nigel Scott Walker	Senior Vice President, Controller and Assistant Secretary
John Michael Welliver	Senior Vice President and Chief Underwriter

Committees

Executive Committee

Roy Frank Mitte
James Martin Grace
Eugene Edgar Payne
Jeffrey Harrison Demgen

Investment/Finance Committee

Roy Frank Mitte
James Martin Grace
Eugene Edgar Payne
Jeffrey Harrison Demgen

Nominating Committee

Roy Frank Mitte
James Martin Grace
Eugene Edgar Payne
Jeffrey Harrison Demgen

Insurance Committee

James Martin Grace
Jeffrey Harrison Demgen
David Clark Hopkins*
Ricardo Alonzo Cruz*

Audit Committee

James Martin Grace

FAMILY LIFE INSURANCE COMPANY

Eugene Edgar Payne
Jeffrey Harrison Demgen
Steven Paul Schmitt
David Clark Hopkins*
Ricardo Alonzo Cruz*

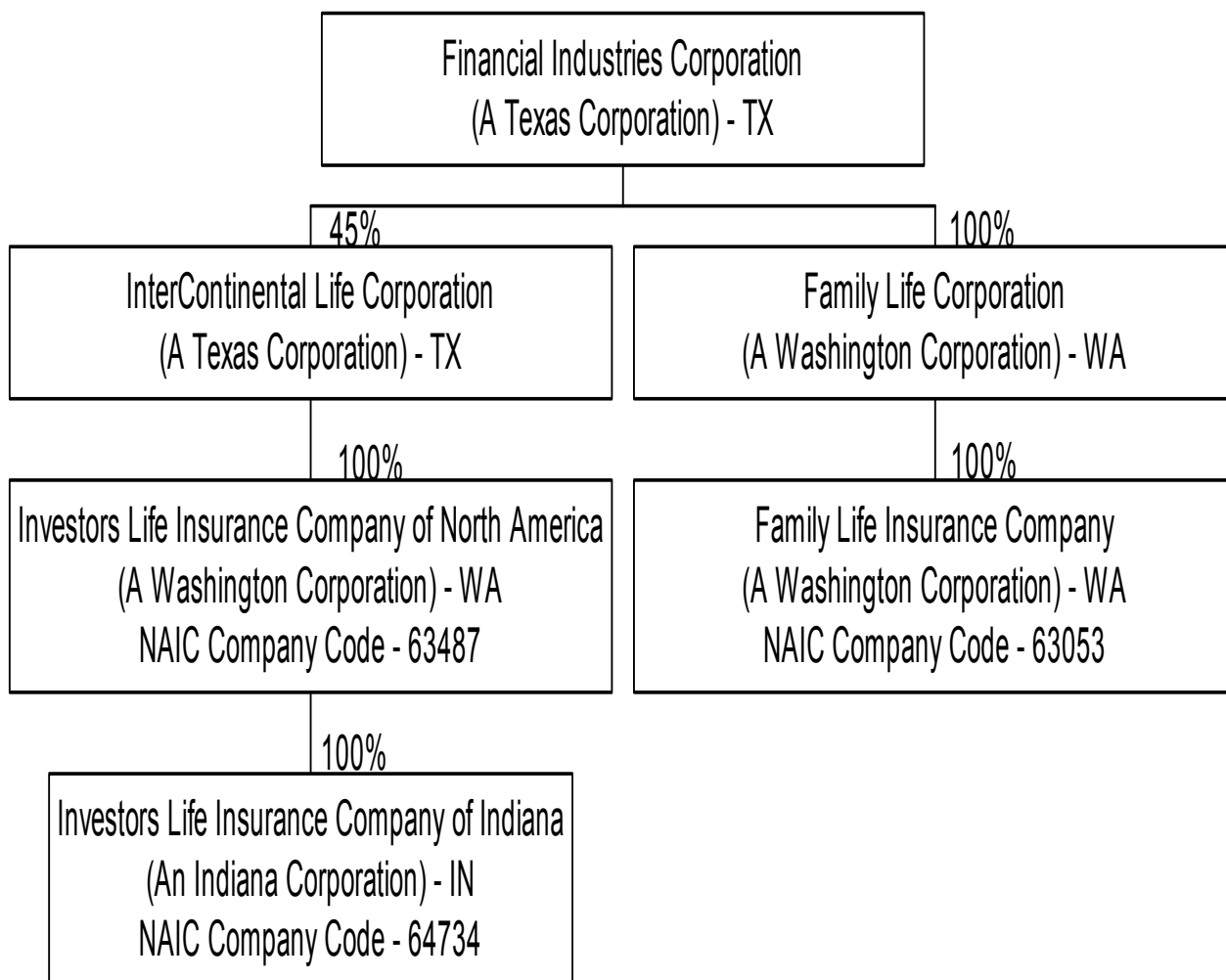
* Non-voting members

Conflict of Interest

The Company has an established conflict of interest procedure for its directors, officers, and key employees. The review disclosed that all directors and officers filed the conflict of interest statements and no conflicts were noted.

The following organization chart is taken from the filed 1998 annual statement:

FAMILY LIFE INSURANCE COMPANY



FAMILY LIFE INSURANCE COMPANY

AFFILIATED COMPANIES

The Company is a wholly owned subsidiary of Family Life Corporation (FLC), a Washington domiciled corporation which was formed in 1991. FLC was a wholly owned subsidiary of Family Life Insurance Investment Company (FLIIC) from 1991 until December, 1998 when FLIIC was dissolved. In connection with the dissolution, all of the assets and liabilities of FLIIC became the obligations of FLIIC's sole shareholder, Financial Industries Corporation (FIC). FIC is an insurance and financial services holding company domiciled in the state of Texas and the ultimate parent company of Family Life Insurance Company.

FIC owns approximately 45% of the outstanding common stock of InterContinental Life Corporation (ILCO), a Texas domiciled insurance and financial services holding company. ILCO owns 100% of the common stock of Investors Life Insurance Company of North America (ILINA) a Washington domiciled life insurance company. ILINA owns 100% of the common stock of Investors Life Insurance Company of Indiana (ILICI), an Indiana domiciled life insurance company. In addition, ILINA owns 100% of the common stock of ILG Securities Corporation, a Pennsylvania corporation, which is a registered broker-dealer. ILINA also owns approximately 5.37% of the common stock of FIC.

As a member of an Insurance Holding Company System, registration statements are required to be filed in accordance with RCW 48.31B.025 and WAC 284-18-300.

Contracts/Service Agreements

The Company filed an individual unconsolidated tax return for 1998. FLIC has an agreement with ILINA by which ILINA pays general expenses for FLIC and allocates the costs back to FLIC. Expense sharing ratios are in place for each cost center and expense item. FLC does not pay any expenses and FIC does not appear to pay a share of the overhead costs related to the group. However, FIC does not charge fees to the Company.

In conjunction with the purchase of FLIC by FIC via FLC and FLIIC, FLIC issued a \$97.5 million surplus note to FLC. FLC in turn borrowed \$30 million from Merrill Lynch & Co., Inc. (ML), \$22.5 million from ILINA and \$50 million from a group of banks. After repayments of the surplus note, the current balance of \$22.8 million is recorded as of December 31, 1998.

Minutes

The minutes of the Shareholders, Board of Directors, and committees of the Board for the period covered under examination were reviewed. The Board adequately approved investment transactions on an annual basis. The unanimous written consent of the Board of Directors and the Executive Committee in lieu of special meetings were fully signed and documented by its members.

INTERNAL SECURITY

Fidelity Bonds

The Company and its parent company, Family Life Corporation (FLC) and/or its ultimate parent holding company, Financial Industries Corporation (FIC), did not maintain a fidelity bond or other insurance to protect the Company against the fraudulent acts of the Company's directors, officers, or employees. It is recommended that the Company obtain either directly or indirectly through Financial Industries Corporation, a fidelity bond. The NAIC suggested minimum amount for such bond for the Company's exposure is \$800,000.

FAMILY LIFE INSURANCE COMPANY

Other Insurance

The prior examination work papers reveal that the examination team recommended that the Company provide directors and officers liability insurance and errors and omission insurance in order to protect policyholders. This particular recommendation has been followed and a general policy covering specific risks was in force as of December 31, 1998 with an authorized insurer. However, it was noted that the Company does have directors and officers liability insurance through a general liability policy and not through a specific directors and officers liability policy.

Internal Controls

The firm of PriceWaterhouse Coopers, Certified Public Accountants, Dallas, Texas, was retained by the Company to audit its statutory financial statements for the years under examination. As part of these audits, reports of internal control structure were issued with no material weaknesses noted.

In addition, the examiners on each line item assigned to them, independently tested internal controls and with the exception of those items referenced in the "Accounting Records" (Page 11) section of this report, no other material weaknesses were found.

Internal Audit Function

The Internal Audit Department of the ultimate parent holding company, Financial Industries Corporation, performs audits of the Company and provides recommendations to management on internal controls and operational procedures.

Other Agreements

Family Life Corporation manages the Company's invested assets under an investment service agreement with the Bank of New York. Examination of the agreement indicates that it should be amended to include the standard by the NAIC pertaining to language requiring indemnification of the Company and also in compliance with RCW 48.03.025 for proper safeguards and security of the Company's assets.

OFFICERS AND EMPLOYEES WELFARE AND PENSION PLANS

The Company, as a member of Family Life Corporation, provides its employees and their dependents with medical, dental, vision care, and life and AD&D benefits. The Company's employees are eligible to participate in the parent company's pension plan; a long term disability plan and a profit sharing savings plan. The Company made adequate provisions in the financial statements for its obligations under these plans.

TERRITORY AND PLAN OF OPERATION

The Company is authorized to transact business in 49 states (except New York), the District of Columbia, American Samoa, Guam, Puerto Rico and the U.S. Virgin Islands as of December 31, 1998.

The Company licenses an exclusive agent sales force of approximately 350 representatives and personal producing sales managers. This national agent force is supervised through 22 regional vice presidents and 2 divisional vice presidents who in turn are managed and report directly to a senior vice president.

The primary sales thrust of the Company is mortgage protection insurance, which is sold through leads provided by lending institutions and internal direct response programs. The total net premiums written and annuity considerations distributions by major product line for the Company for 1998 was 94.8%, ordinary and group life insurance, most of this being reducing term; 3.6%, accident and health; 1.6%, ordinary individual annuities.

FAMILY LIFE INSURANCE COMPANY

GROWTH OF COMPANY

The growth of the Company for the past five years is reflected in the following exhibit prepared from the filed annual statements and as adjusted by this examination:

(000's Omitted)					
<u>Year</u>	<u>Assets</u>	<u>Liabilities</u>	<u>Capital</u>	<u>Surplus</u>	<u>Premiums and Annuity Consideration</u>
1994	143,586	116,920	22,756	3,910	56,339
1995	141,879	116,085	22,756	3,038	57,265
1996	132,851	107,932	17,692	7,227	50,175
1997	137,891	107,504	17,692	12,695	46,797
1998*	134,788	106,697	17,692	10,400	43,481

*As adjusted by this examination.

REINSURANCE

Assumed

As of December 31, 1998, the Company has assumed only life reinsurance from an affiliate, Investors Life Insurance Company of North America (ILINA). The amount of in-force totaled \$6,159,260 with a reserve of \$115,865. The Company entered into this agreement on January 1, 1996.

Ceded

The Company's maximum retention for individual life insurance is \$200,000, with a minimum cession of \$10,000. All reinsurance agreements are with reinsurers that are rated A+ to B+ by a recognized reinsurer rating entity. All reinsurers are authorized to transact business in the state of Washington. Subsequent to the prior examination, the Company entered into two reinsurance agreements. No unusual provisions or lack of provisions which are material to the examination were noted. The treaties include an insolvency clause in compliance with RCW 48.12.160 (3).

The Company and its affiliate, ILINA have jointly entered into a catastrophe reinsurance agreement with Connecticut General Life Insurance Company through an intermediary, John B. Collins Associates, Inc. The preamble of the reinsurance agreement indicates that ILINA, "shall be deemed the authorized representative of the FIC Insurance Group in Austin, Texas, for purposes of sending and receiving notices." The companies jointly pay a total annual minimum premium of \$500 (which it is stated that both would each have to pay the minimum \$500 annual premium if they entered into separate agreements on their own behalf). However, the reinsurance agreement does not indicate the accounting process for determining which of the companies owes whatever portion of the premium or any transactions that may occur in connection with the agreement. The reinsurance agreement does indicate that this particular agreement covers certain policies issued by the Company in Florida. This is separate from what ILINA is reinsuring. This transaction is not in compliance with RCW 48.31B.030 (1)(b)(iv). This reinsurance arrangement could be construed to be a "cost sharing agreement". Additionally, RCW 48.31B.025(2)(c) requires that the transaction between the two companies be filed with the Washington Office of Insurance Commissioner. The Company is instructed to comply with RCW 48.31B.030(1)(b)(iv) and 48.31B.025(2)(c)(vi). (See Instruction #17, Page 3)

It was also noted that FIC Insurance Group, which is listed in the reinsurance agreement, is not listed in Schedule Y of the 1998 Annual Statement, which is not in compliance with RCW 48.05.250 regarding proper listing of affiliates or subsidiaries. The Company is instructed to comply with RCW 48.05.250 regarding proper listing of affiliates or subsidiaries in Schedule Y of the 1998 Annual Statement. The Company has indicated that "FIC Insurance Group is

FAMILY LIFE INSURANCE COMPANY

not a legal entity. The examiners believe that the reinsurance agreement is, therefore, not valid. (See Instruction #18, Page 3)

Effective July 1, 1997, the Company ceded on a 100% quota share coinsurance basis all of its accident and health business to United Teacher Associates Insurance Company (UTA) of Austin, Texas. In connection with the UTA coinsurance agreement, UTA entered into an assumption reinsurance agreement with the Company wherein UTA would fully transfer/assume the affected accident and health policies once certain requirements were met. While this is not a problem, per se, the manner in which the two companies went about the notice to the affected policyholders does not comply with Chapter 284-95 WAC – Transfer of Insurance Contracts. The Company is instructed to comply with Chapter 284-95 WAC regarding proper transfer of insurance contracts. (See Instruction #19, Page 3)

ACCOUNTING RECORDS AND PROCEDURES

Accounting Records

The Company's accounting procedures, internal controls, and transaction cycles were reviewed during the planning phase of the examination and a trial balance was prepared for the year ended December 31, 1998. The Company currently maintains only its premium accounting function in Seattle, Washington. FLIC maintains all other administrative and accounting functions at its parent's corporate headquarters in Austin, Texas. The Company agreed with the Washington Office of the Insurance Commissioner to keep certain copies of its records in its Seattle, Washington home office. However, during the period of the examination, the examiners found the maintenance of these records inadequate and additional information had to be forwarded from Austin, Texas.

Some of the Company's accounts and records consist of microfiche copies of Monthly Transaction Summary run from the ABC general ledger system. The Company had account balances that it could not support. Asset and liability balances in the general ledger remain unchanged after its merger with another company. Numerous requests for information from the Austin administrative office, where most records are maintained, took weeks and sometimes months to get a response. The responses received were often incomplete and/or inaccurate, and additional requests for the information were required. The response time improved during the examiners' on-site work in the administrative office in Austin, but the underlying cause of incomplete and inadequate records still existed.

During the course of the examination and in the prior examination report, it was noted that the condition of the financial records made it impossible for prompt review and verification by the examiners. In certain instances, the Company's record keeping practices did not allow for the accurate reporting of balances in the Company's internal financial records or on the annual statements filed with the Washington Office of the Insurance Commissioner. The Company did not exercise due care in its maintenance of books and records in a manner that would provide accurate and verifiable financial statements with adequate supporting documentation. The Company's external auditors made a recent comment with which the examination team concurs that the Company and its affiliate, Investors Life Insurance Company, did not timely, or accurately, perform its reconciliations of its various bank accounts. The prior Examination Report also indicated that the Company used incorrect balances in its bank reconciliations. The Company has not made any serious attempts to properly and timely reconcile its bank accounts to determine the true and correct balances at the end of each month. In addition, the Company was cited and fined several thousand dollars during the last examination for similar conditions.

It is strongly recommended that the Company comply with RCW 48.05.280 and 48.05.250 to ensure full and accurate accounts and records to facilitate the examination, and to ensure accurate annual statement reporting.

During the review covered under this examination, the information system utilized by the FIC and ILCO holding groups was composed of five computer operating systems and thirteen major policy software applications. As the result of a major three-year conversion and Y2K project completed in late 1999, these systems were consolidated into one operating system and three policy application systems.

FAMILY LIFE INSURANCE COMPANY

The multiplicity of operating systems and applications software is the result of recent mergers and acquisitions of additional lines of business. The previous control weaknesses, associated with the multiple systems and applications, listed below have now been eliminated or greatly reduced as a result of the three-year conversion/Y2K project.

Programs have incomplete or missing source code and documentation. Complex user training requirements resulting in a long learning curve for new users. A high level of manual operations and an increase in service requests to automate the manual operations. Several application systems are unsupported by vendors. System support and operations is difficult.

There is a backlog of work necessary for maintaining current systems and accomplishing proposed plans to consolidate. The Company is currently in the process of adding staff in this area.

A review of Remittances and Items not Allocated disclosed a number of outstanding suspense items over 90 days old indicating that the Company does not adequately clear such items. As the Company does account for all amounts received but does not properly complete the application of the amount or amount received; the liability established by the Company was accepted in this examination. However, it is recommended that the Company thoroughly review this liability and either fully and properly apply the amounts in suspense or refund the amounts received to the proper party. (See Comments and Recommendations #3, Page 3)

Actuarial Opinion

The Washington Office of the Insurance Commissioner used a zone actuary from the Montana Department of Insurance to review the life and accident and health reserves. It was determined that the Company is in non-compliance with Titles 48 RCW and 284 WAC. The issues of non-compliance regarding recordkeeping and financial reporting are outlined in the "Notes to Financial Statements", Page 18 of this report.

SUBSEQUENT EVENTS

There are no significant financial events, beyond the activities in the normal course of business experienced by the Company, after December 31, 1998.

COMMENTS ON RECOMMENDATIONS FROM PREVIOUS EXAMINATION

Some of the comments and recommendations made in the last examination were not addressed to the satisfaction of the examiners on this examination, as commented in the "Accounting Records and Procedures" and "Notes to Financial Statements" sections of this report. It is again strongly recommended that the Company comply with RCW 48.03.030 and 48.05.250 to facilitate the examination, and to ensure accurate financial reporting.

FINANCIAL STATEMENTS

The following statements present the financial condition of the Company as of December 31, 1998 as determined by this examination:

Balance Sheet
Summary of Operations
Comparative Balance Sheet
Comparative Summary of Operations
Reconciliation of Capital and Surplus

FAMILY LIFE INSURANCE COMPANY



Microsoft Excel
Worksheet

**(THE ABOVE ICON CONTAINS ALL OF THE FINANCIAL STATEMENTS FOR THIS COMPANY AS LISTED
BELOW)**

Balance Sheet
Summary of Operations
Comparative Balance Sheet
Comparative Summary of Operations
Reconciliation of Capital and Surplus

FAMILY LIFE INSURANCE COMPANY

Summary of Operations
For Year Ended December 31, 1998

FAMILY LIFE INSURANCE COMPANY

Comparative Balance Sheet
Examination as of December 31, 1998

FAMILY LIFE INSURANCE COMPANY

Comparative Summary of Operations
Examination as of December 31, 1998

FAMILY LIFE INSURANCE COMPANY

Reconciliation of Capital and Surplus
Examination as of December 31, 1998

FAMILY LIFE INSURANCE COMPANY

NOTES TO FINANCIAL STATEMENTS

(A) Cash on hand and Short term investments– The Company included in its asset for cash a balance that was not the true year-end balance of the Company's operational checking account, and failed to use the true and reconciled balance on its 1998 Annual Statement which is not in compliance with Chapter 48.05.280 RCW. The Company's bank account with Wells Fargo Bank appears to have been overstated in the 1998 Annual Statement by \$63,005 due to the fact that the Company used the unreconciled amount. The amount of overstatement was immaterial but the difference was posted to the variance list, which in the aggregate was included in the adjustment. (See Instruction #6, Page 2)

Furthermore, the Company continued to carry a considerable number of outstanding checks that were issued prior to 1993 dating back to early 1991 which is not in compliance with Chapter 48.05.280 RCW. These checks should have been escheated to the various jurisdictions and taken off of the bank reconciliation. (See Instruction #6, Page 2)

The Company also failed to include in its asset for cash one inactive checking account which is not in compliance with Chapter 48.05.250 RCW. The amount in this checking account was immaterial. Therefore, the examiners recommend that the Company close this account. (See Instruction #6, Page 2)

In addition, in the review of short-term investments, it was noted that the Company invested in Money Market Funds that were not listed in the NAIC SVO Mutual Funds listing which is not in compliance with RCW 48.03.025. (See Instruction #7, Page 2)

(B) Federal Income Tax Recoverable – The Company did not file consolidated tax returns for 1998. The review of the 1998 tax returns indicated a refund was due in the amount of \$329,105. However, the 1998 Annual Statement showed that the Company was expecting an estimated refund of \$608,829 or an overstatement of \$279,724 in the asset account. Due to the immaterial amount, the difference was posted to the variance list, which in the aggregate was included in the adjustment.

The prior examination workpapers disclosed discrepancies in trying to verify the accuracy of the federal income tax recoverable as reported in the 1991 through 1993 Annual Statements. The Financial Analyst from the Washington Office of the Insurance Commissioner also became involved in the reconciliation of this amount. The current examination tried to perform the same analytical review as in the previous examination and encountered similar problems. It appears that due to the Company's method of determining its federal income tax recoverable or payable, the amount will not reconcile. It was determined that the federal income tax recoverable reported by the Company in its 1998 Annual Statement was not accurate and the Company should change its method of determining the amount of the receivable in compliance with RCW 48.05.280. (See Instruction # 8, Page 2)

(C) Life Insurance Premiums and Annuity Considerations Deferred and Uncollected – \$580,751 - Per the actuarial computational adjustments made are described as follows:

Smoker Policy Recalculation – In valuing its traditional life insurance policies, the Company failed to recognize policies issued after 1991 on a smoker basis. Based on the Company's re-calculation as of December 31, 1999, the examination team's consulting actuary estimated an increase of \$597,939 to the December 31, 1998 net due and deferred premium asset.

Leisure Life Recalculation – The Company's worksheet for calculating reserves, and due and deferred premiums for the Leisure Life's policies used incorrect reserve, net premium, and modal premium factors. The Company's re-calculation decreases the reported asset by \$28,244.

Bulk ADB Reinsurance Agreement – Under the Company's bulk accidental death benefit (ADB) reinsurance agreement with CIGNA, premiums are estimated and paid at the beginning of the calendar year. Because ADB in-force insurance decreased during 1998, the Company accrued an \$11,056 premium refund as of December 31, 1998.

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The net effect of these adjustments is a \$580,751 increase to Life Insurance Premiums and Annuity Considerations Deferred and Uncollected.

(D) Aggregate Reserve for Life Policies and Contracts - \$2,246,584 – The actuarial computational adjustments made are described as follows:

Smoker Policy Recalculation – In valuing its traditional life insurance policies, the Company failed to recognize policies issued after 1991 on a smoker basis. Based on the Company's reserve re-calculation as of December 31, 1999, the examination team's consulting actuary estimated a reserve increase of \$1,265,907 as of December 31, 1998.

Leisure Life Recalculation – The Company's worksheet for calculating reserves, and due and deferred premium for the Leisure Life policies used incorrect reserve, net premium, and modal premium factors. The Company's re-calculation decreases the reported reserve by \$35,105.

Universal Life Family Benefit Riders – The examination team's consulting actuary found a block of universal life riders for which the Company did not calculate reserves. The Company estimates that an additional reserve of \$30,000 is required for these riders.

Universal Life Policies – The examination team's consulting actuary noted the following three areas where the Company is required to increase reserves on its universal life policies as follows:

Minimum Valuation Standards – Under RCW 48.74.050(1) and 48.74.060, the most conservative of the mortality and interest assumptions defined by the policy guarantees for the purpose of defining benefits, or for the purpose of valuation under the minimum standard set forth in RCW 48.74.030, should be used in calculating reserves.

The Company utilized the interest rates specified in RCW 48.74.030(3), rather than the more conservative interest rates defined by the policy guarantees, in determining its universal life reserves. Based on a Company prepared re-calculation of the universal life reserves for Family Life Insurance Company, the examination consulting actuary estimated a reserve increase of \$1,727,036 as of December 31, 1998 for the Mortgage Protection Plus (MPP) and Primary Universal Life policies. The examination consulting actuary further estimated a \$96,637 reserve increase as of December 31, 1998 for the 110/210 Universal Life policies.

Cost of Insurance Deductions – Under the terms of the Company's universal life policies, deductions for the cost of insurance are made at the beginning of each policy month. As of December 31, 1998, a portion of each deduction was unearned and should have been held as a reserve. The examination consulting actuary estimated additional reserves of \$127,793.

Accrued Interest to December 31, 1998 – Year-end reserves for the 110/210 Universal Life policies do not include interest that had accrued to December 31, 1998. The examination consulting actuary estimated additional reserves of \$2,247 for the 110/210 Universal Life policies.

Universal Life Policies – Reinsurance Ceded – The Company cedes to Investors Life Insurance of North America Company universal life policies written since 1994. The examination consulting actuary's re-calculation of the reserves on the ceded policies to reflect minimum valuation standards, cost of insurance deductions, and accrued interest to December 31, 1998, combined with a worksheet correction, increases the reinsurance ceded reserve credit by \$375,861. (See Instruction #16, Page 3)

Deficiency Reserves – The Company's re-evaluation of which policies require deficiency reserves resulted in a reserve decrease of \$81,458.

Family Benefit Claim Reserves – The Company's Family Benefit Rider on its traditional life insurance policies provides for paid-up spouse and children life insurance in the event that the base insured dies. The Company

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conservatively reserved this paid-up benefit by using the sum of the policy's active life reserve and the present value of the premiums being waived. Under a more realistic reserving methodology, that defines the reserve as the single premium of the paid-up benefits, the reserve for these policies decreases by \$628,883.

Bulk ADB Reinsurance Ceded Reserves – As of December 31, 1998, the Company had in-force a bulk accidental death benefit (ADB) reinsurance agreement with CIGNA. Under the terms of this agreement, either party giving 90 days notice can cancel the reinsurance coverage for new and existing business. Thus, for reserving purposes, the treaty is considered to be a short-term insurance contract. Since the agreement is a short-term contract, and since a policy year under the agreement is defined as a calendar year, the December 31, 1998 reinsurance ceded reserve credit of \$118,271 is disallowed. (See Instruction #16, Page 3)

The net effect of these adjustments is a reserve increase of \$2,246,584 to the Aggregate Reserve for Life Policies and Contracts.

(E) Life Policy and Contract Claims - \$186,121 – The reported liability is comprised of resisted claims, due and unpaid pending claims, and an estimate of claims incurred but not yet reported to the Company as of December 31, 1998.

The Company's paid claims experience through August 31, 2000, together with an estimate of remaining payments on claims incurred prior to December 31, 1998, indicates that the reported liability is understated by \$186,121.

The following instructions will result in a more accurate statement of the actuarial assets, reserves, and liabilities in future financial statements (refer to D and E above):

- The Company must maintain a comprehensive file of the procedures followed and of the data sources used to prepare the actuarial assets and liabilities. This information will facilitate future actuarial examinations, and would also assist the Company in preparing future quarterly and annual statements in compliance with RCW 48.05.280. (See Instruction #9, Page 2)
- The Company must review and modify where necessary, the current reserving methodology and procedures applicable to its universal life insurance policies. The reserving methodology must comply with RCW 48.74.050 (1) and 48.74.060, as well as reflect the provisions of the Company's policy forms. Areas of emphasis include using required valuation standards for interest rates and mortality tables, properly treating the monthly cost of insurance deductions, and accruing interest to the statement date. (See Instruction #10, Page 2)
- The Company must reflect the smoking status of the insured in calculating reserves and net due and deferred premiums for traditional life insurance policies. This recommendation was implemented during the preparation of the 1999 Annual Statement.
- The Company must review the appropriateness of the reserve treatment under its bulk ADB reinsurance agreement, which is not in compliance with RCW 48.12.160(1). (See Instruction #11, Page 2)
- The Company must review the appropriateness of its deficiency reserve in compliance with RCW 48.05.280 and 48.74.030. (See Instruction #12, Page 2)
- The Company has a number of reserves for which current reserving practices are a carryover from that of the previous owner. Although these reserves are generally small, the Company must review the calculations and reserving practices that have sound actuarial bases in compliance with 48.74.030. (See Instruction #13, Page 2)
- The examination consulting actuary's review of the payment history of the Company's life insurance claims indicated that there are often delays in reporting the deaths of insured to the Company. The Company must adopt a methodology for estimating the liabilities for outstanding death claims that reflects these reporting delays in compliance with RCW 48.74.030. (See Instruction #14, Page 2)

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(F) **Asset Valuation Reserve** – The review of this account disclosed that the basic contribution, reserve objective and maximum reserve calculation default component has not properly allocated the bonds between exempt obligations and highest quality. The difference of \$7,727 in the AVR at December 31, 1998 was below the tolerable error level established in the planning phase of the examination. However, the difference should be posted to the variance listing for consideration when all other changes are taken in the aggregate in compliance with RCW 48.05.250. (See Instruction #15, Page 2)

COMMENTS ON FINANCIAL STATEMENTS

(1) **Bonds**

\$76,710,422

The Company's investment in bonds represents 57% of its total admitted assets as of December 31, 1998. The bond portfolio consisted of the following:

<u>Classification</u>	<u>Statement</u>	<u>Par</u>	<u>Market</u>
	<u>Value</u>	<u>Value</u>	<u>Value</u>
U.S. Government	\$ 28,504,868	\$ 28,226,300	\$ 29,623,426
States, Territories and Possessions	4,966,020	5,000,000	5,230,000
Special Revenue	29,004,613	29,191,983	29,044,613
Public Utilities	3,473,210	3,500,000	3,745,000
Industrial and Miscellaneous	10,761,711	10,750,000	11,011,222
Total	<u>\$ 76,710,422</u>	<u>\$ 76,668,283</u>	<u>\$ 78,654,261</u>

Bonds, not backed by other loans, are valued at lower of amortized cost or investment value based on the NAIC Valuation of Securities. Discount or premium on bonds is amortized using the effective interest method. For loan-backed bonds, anticipated prepayments at the date of purchase are considered when determining the amortization of discount or premium.

The review of bonds indicated that the Company's Custodial Agreement did not contain the language required by the NAIC Financial Examiners' Handbook, "that the bank or trust company as custodian is obligated to indemnify the insurance company for any loss of securities of the insurance company in the bank or trust company's custody occasioned by the negligence or dishonesty of the bank or trust company's officers or employees, or burglary, robbery, holdup, theft, or mysterious disappearance, including loss by damage or destruction. That, in the event of a loss of the securities for which the bank or trust company is obligated to indemnify the insurance company, the securities shall be promptly replaced or the value of the securities and the value of any loss of rights or privileges resulting from said loss of securities shall be promptly replaced." (See Instruction #1, Page 2)

During the examination, the above agreement was amended to include the standard required by the NAIC and to comply with RCW 48.03.025.

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(2) Real estate: Investment real estate

During 1996 and 1997, the Company acquired an unimproved parcel of property (known as the Bridgepoint Five Building) to build a “home office”. The Company sold the property, plus improvements, before the construction of the building was complete in November 1997. As of year-end 1998, the Company did not have any real estate investments.

The Company was not in compliance with the provisions of RCW 48.13.160 (4)(b) in its investments in the Bridgepoint Five Building. The cost of the real estate acquired in 1996, amounting to \$1,373,708 plus the estimated cost to the Company of the actual improvements incurred during 1996 and 1997 of \$10,542,635, exceeded the 4% investment limitation (December 31, 1995 admitted assets: \$141,879,428 X 4% = \$5,675,177). If the Company had estimated its costs of improvements to be less than the amount actually expended of \$10,542,635, the amount estimated for such improvements would have to be below \$4,301,469 to be admitted. (See Instruction #3, Page 2)

The Company was also not in compliance with RCW 48.13.140(1) and RCW 48.13.350(2)(c). It did not obtain an appraisal of the property known as the Bridgepoint Five Building that the Company acquired and began to develop in 1996 as a “home office” but was sold in 1997. The Company also did not obtain such an appraisal subsequent to its acquisition. The Board of Directors approved the acquisition of the property without the appraisal. The approval of the acquisition of the property also did not indicate the type or classification of the real estate acquired. (See Instruction #3, Page 2)

The Company’s affiliate, Investors Life Insurance Company of North America (ILINA), acquired four unimproved parcels of property (known as the Bridgepoint One through Four Buildings) adjacent to the Company’s acquisition as investment property as noted in the Form 10-K as issued by the ultimate parent company, Financial Industries Corporation (FIC). ILINA sold the four properties in November 1997 when FLIC sold its entire interest in the adjoining properties to the same single, but unaffiliated, investor. The Company acquired this particular parcel of property and began construction of a building thereon as an overall plan of real estate development by the holding company. The holding company used the life insurance companies (Family Life and Investors Life) to finance the project.

During the review of the Company’s records that should be maintained for each parcel of real estate property for either home office or investment in real estate, it was noted that the Company did not maintain adequate hazard insurance on some of the respective properties. The evidence of insurance provided to the examination team was that the parent company, Financial Industries Corporation had a general liability policy. As each parcel of real estate held was not specifically listed as being covered, the Company is not in compliance with RCW 48.13.140(2). (See Instruction #4, Page 2)

It is noted that when the Company sold the Bridgepoint property in 1997, it paid a commission to an affiliate, FIC Realty Service, Inc. It was also noted that this affiliate was not listed in Schedule Y –Part 1 – Organization Chart or in Schedule Y – Part 2 – Summary of Insurer’s Transactions with Any Affiliates in the 1998 Annual Statement. This does not appear to be in compliance with RCW 48.31B.030(1)(a)(iv), RCW 48.05.250, and WAC 284-07-050(2). (See Instruction #5, Page 2)

FAMILY LIFE INSURANCE COMPANY

ACKNOWLEDGMENT

In addition to the undersigned, Richard Randour, CFE, CPA, from Delaware, Timothy Hurley, CFE, from Oregon, and Thomas L. Burger, FSA, MAAA, actuary from the Montana Department of Insurance, participated in the examination and preparation of this report.

TIMOTEO L. NAVAJA, CFE, CIE
Examiner-in-Charge
State of Washington

LARRY E. CROSS, CFE, CIE
Representing Northeastern Zone
State of Delaware

FAMILY LIFE INSURANCE COMPANY

AFFIDAVIT

[illegible]

I, TIMOTEO L. NAVAJA, being duly sworn, deposes and says that the foregoing report subscribed by him is true to the best of his knowledge and belief.

TIMOTEO L. NAVAJA, CFE, CIE

Subscribed and sworn to before me on this _____ day of _____, 2001.

Notary Public in and for the State
of Washington.